The Duck That Broke the Camel's Back

What *SIFMA v. CFTC* Means for U.S. Swaps Regulation

By Robert Brown, Nathan Howell, Michael Sackheim and Joseph Schwartz

The cross-border application of Dodd-Frank is one of the thorniest issues now facing the Commodity Futures Trading Commission and the industry it regulates. The CFTC's policy in this area is set out in "guidance" rather than rules, an unusual format for a matter so critical to the functioning of the derivatives markets. Three trade associations challenged this approach by filing a lawsuit against the CFTC arguing that the guidance should be thrown out and replaced by a normal rule-making process. The court issued its decision on Sept. 16. In the following article, four lawyers assess the ruling and the future of CFTC policy in this area.

In July 2013, the Commodity Futures Trading Commission—the primary derivatives regulator in the United States—issued a self-styled "interpretive guidance and policy statement" on the cross-border application of the swaps provisions of the Commodity Exchange Act and the CFTC's related rules (the "Cross-Border Guidance"). The CFTC had been granted a broad mandate to regulate the swaps markets under Title VII of the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act, which had been adopted in response to the global financial crisis two years earlier. The CFTC subsequently adopted a number of complex rules implementing Dodd-Frank, and the Cross-Border Guidance represented the expansive vision of the CFTC and then-Chairman Gary Gensler for the application of those rules to cross-border activities.

Several months after the CFTC issued the Cross-Border Guidance, the CFTC staff issued Advisory 13-69, in which the staff further asserted cross-border jurisdiction over swaps activities between non-U.S. persons where certain conduct occurred inside the United States. The Advisory was not well-received by the swaps industry, both domestically and abroad. It was issued unilaterally by the CFTC staff, and the public had no opportunity to comment on it. The then-chairman of the International Swaps and Derivatives Association was quoted as saying that the policy articulated in the Advisory "was the straw that broke the camel's back." ISDA joined the Securities Industry and Financial Markets Association and the Institute of International Bankers as plaintiffs in *SIFMA v. CFTC*, challenging the Cross-Border Guidance and the cross-border application of the CFTC's substantive swaps rules.

In September 2014, a D.C. district court issued a decision largely rejecting the industry's challenges to the Cross-Border Guidance. A key point of contention in the case was whether the Cross-Border Guidance constituted a legislative rule, interpretive rule or policy statement (as discussed further below). The court held that the Cross-Border Guidance was mostly a non-binding policy statement. In reaching this conclusion, the court embraced what it referred to as the "now infamous 'duck test'"—if it looks like a duck (policy statement), walks like a duck (policy statement) and quacks like a duck (policy statement), it is a duck (policy statement).

For now, it seems that the CFTC has survived a major challenge to its Cross-Border Guidance. However, what the decision means for the future of cross-border swaps regulation remains to be seen, as the CFTC's extra-territorial jurisdiction will be shaped by the views of the post-Gensler CFTC, and those views are continuing to evolve.

The Cross-Border Guidance

The root of the dispute is that the text of the CEA does not set forth the extent of the CFTC's jurisdiction over cross-border swaps activities in a clear and unambiguous manner. Section 2(i) of the CEA states that the CEA's swaps provisions and the CFTC's swaps rules apply "to activities outside the United States," if those activities "have a direct and significant connection with activities in, or effect on, commerce of the United States." The text does not define, however, what "direct and significant connection" might mean, leaving it to the CFTC and courts to determine over time.

> Embarking on this [margin] rulemaking indicates a willingness to reopen certain aspects of the Cross-Border Guidance and to move beyond the procedural circumstances that gave rise to *SIFMA v. CFTC*.

The Cross-Border Guidance set forth the CFTC's framework for determining what entities and cross-border swaps activities have the requisite U.S. connection, by dividing the swaps rules into so-called "transaction-level requirements" (e.g., clearing, trade execution, reporting and recordkeeping requirements) and "entity-level requirements" (e.g., capital and risk management requirements for swap dealers). The Cross-Border Guidance also presented the CFTC's views as to which entities, under certain circumstances, would be eligible to comply with the regulations of their home-country regulators (i.e., substituted compliance) in lieu of complying with the CFTC's swaps rules.

Under the Cross-Border Guidance, the application of the CFTC's swaps rules in the cross-border context depends in large part on whether one of the counterparties falls within the CFTC's broad definition of "U.S. person," which includes foreign branches of U.S. persons. Foreign entities that are guaranteed by or that serve as conduits for U.S. affiliates, although not U.S. persons, are also subject to many of these rules.

Aside from the fairly broad and general language used in the Cross-Border Guidance and the relative lack of bright line tests,

the Cross-Border Guidance also presents a number of interpretive issues, leaving market participants with a number of gray areas in determining how best to comply. While the CFTC has attempted to address some of these issues through no-action letters and advisories, many questions remain unanswered.

SIFMA v. CFTC and the Duck Test

The court's decision in *SIFMA v. CFTC* ultimately hinged on questions of procedure. The plaintiffs alleged that the CFTC failed to follow the notice-and-comment or cost-benefit analysis procedures normally required of agency rulemakings. Those procedural hoops would only be required, however, if the Cross-Border Guidance was a "legislative rule."

Agency rule-making and policy-making generally comes in three varieties: legislative rules, interpretive rules and policy statements. Legislative rules are substantive changes to a legal regime and impose legally binding requirements, while interpretive rules and policy statements are non-binding and only serve to provide interpretation of, or guidance for, already existing legal requirements. Legislative rules are considered to be "final agency actions" and they are entitled to *Chevron*-deference when reviewed by a court, which means the court will defer to the agency's interpretation of its governing statutes, provided that such interpretation is not unreasonable. Interpretive rules and policy statements, in contrast, do not require notice-and-comment rulemaking procedures and, as they are not "final agency actions," they are not judicially reviewable under the Administrative Procedure Act.

The court in *SIFMA v. CFTC*, in distinguishing among these three categories, applied what it referred to as the "duck test"—evaluating how the agency action looks, sounds and acts. That is, if it is not explicitly labeled by the agency as a "rulemaking" or published in the Code of Federal Regulations, does not read like a legally-binding requirement and does not serve as the legal basis for enforcement actions, then the court will not categorize it as a legislative rule.

Applying this framework, the court concluded that the Cross-Border Guidance was not a legislative rule, because no one reading it "could ... reasonably construe it as setting forth binding norms." Therefore, it did not matter whether the CFTC engaged in notice-and-comment rulemaking or conducted a cost-benefit analysis. Failure to do so was not fatal to the Cross-Border Guidance, and it survived intact.

Procedure v. Substance

Although the court's decision may vindicate the procedures that produced the Cross-Border Guidance, it should not be understood as an endorsement of the substance of the Cross-Border Guidance. While the plaintiffs lodged a substantive challenge—claiming the Cross-Border Guidance was an "arbitrary and capricious" interpretation of the CEA's jurisdictional provisions—the court sidestepped that issue. In the court's view, if and when the CFTC applies the Cross-Border Guidance in an enforcement action or lawsuit, the substance of the CFTC's actions will be ripe for judicial review, and the CFTC would need to be prepared to support its cross-border policies "as if [the Cross-Border Guidance] had never been issued."

Cost-Benefit Analysis

While the plaintiffs' procedural challenge to the Cross-Border Guidance was dismissed, the court agreed with the plaintiffs' argument that the CFTC's cost-benefit analysis of the swaps rules failed to take into account their extraterritorial application. Consequently, the court remanded the rules, instructing the CFTC to perform the required cost-benefit analysis. This requirement is not intended to be "particularly demanding," with the CFTC just required to demonstrate that it has considered and evaluated the rules' full range of costs and benefits.

Having identified this procedural infirmity, the court nevertheless left the relevant rules in full effect, as it believed that a new cost-benefit analysis, while required, likely will be of little significance. While the CFTC will now presumably perform this cost-benefit analysis, the court did not—and market participants should not—expect the analysis to result in any changes to the CFTC's swaps rules or the Cross-Border Guidance.

Where Does This Leave Us Going Forward?

As a result of the court's decision, the Cross-Border Guidance survives intact and continues to serve as a guide to the CFTC's broad interpretation of the jurisdictional reach of its swaps rules. However, the court stressed that the Cross-Border Guidance was non-binding on both the market and regulators, and the court in no way endorsed or approved its substance. It is unlikely the CFTC can successfully argue in a future enforcement action that non-compliance with its interpretation of its cross-border jurisdictional authority constitutes a violation of the CEA or CFTC regulations.

Further complicating matters, Timothy Massad, the new CFTC chairman, has indicated that certain "tweaks" to the Gensler-era Dodd-Frank rulemakings should be expected. New commissioner Chris Giancarlo has also singled out the Cross-Border Guidance as needing revision, raising concerns that its inconsistencies with foreign regulatory regimes could lead to a "trade war in financial markets" and warning that it is "wreaking havoc and forcing U.S. financial institutions to retreat from what were once global markets."

Whether these developments will translate to substantive changes to the CFTC's approach to cross-border issues is an open question. However, we may learn more by observing how the CFTC handles two open issues: the application of the swaps rules to U.S.-based activities of non-U.S. swap dealers, and the cross-border application of margin rules for uncleared swaps.

U.S.-Based Activities of Non-U.S. Swap Dealers

As noted above, CFTC Advisory 13-69—which expressed the staff's view that a "non-U.S. swap dealer regularly using personnel or agents located in the U.S. to arrange, negotiate or execute a swap with a non-U.S. person generally would be required to comply with the transaction-level requirements"—was met with surprise and resistance within the swaps industry. After issuing the Advisory, the CFTC granted no-action relief until Dec. 31, 2014 to non-U.S. swap dealers from certain transaction-level requirements covered by the Advisory to afford affected mar-

ket participants some time to come into compliance. Additionally, in January 2014, the CFTC requested public comment on whether the CFTC should, among other things, adopt the Advisory as Commission-level policy. The CFTC received 22 comment letters, but, to date, has taken no further action.

This sequence of events, followed by the court's decision, leaves the market in a state of limbo. The no-action relief will soon expire, and the court's decision preserving the Cross-Border Guidance effectively brings the Advisory back to full strength. However, the CFTC's request for public comment on the Advisory indicates that further action may be forthcoming.

Margin Requirements for Uncleared Swaps

The CEA requires the CFTC and U.S. prudential regulators, such as the Federal Reserve, to adopt rules imposing uncleared swaps margin requirements on swap dealers. Under the Cross-Border Guidance, margin for uncleared swaps is categorized as a transaction-level requirement and applies to a non-U.S. swap dealer's uncleared swaps with U.S. person counterparties. However, in its September 2014 release announcing proposed uncleared swaps margin rules, the CFTC indicated that it may jettison the Cross-Border Guidance's approach to margin in favor of an approach proposed by the prudential regulators. This is significant because the prudential regulators utilize a significantly narrower definition of U.S. person. By adopting this approach, the CFTC would cede some of the extraterritorial jurisdiction it claimed in the Cross-Border Guidance, at least with respect to the uncleared swaps margin rules.

Additionally, while most of the CFTC's cross-border swaps regulation would remain a non-binding policy, the CFTC's cross-border approach regarding margin for uncleared swaps would take the form of a legislative rule. Even if the CFTC ultimately elects not to retreat from the Cross-Border Guidance's approach to margin regulation, embarking on this rulemaking indicates a willingness to reopen certain aspects of the Cross-Border Guidance and to move beyond the procedural circumstances that gave rise to *SIFMA v. CFTC*.

Conclusion

After years of Dodd-Frank rulemakings, the CFTC is in a period of transition. It is as if the CFTC is moving from being an army of conquest to being an army of occupation. Rather than seeking new jurisdictional territory, the CFTC must now decide how best to govern the territory it has claimed and determine whether the borders it has staked out are defensible, or even desirable. While the decision in *SIFMA v. CFTC* resolves—at least for now—questions about the procedural legitimacy of the Cross-Border Guidance, the actual cross-border application of the CFTC's swaps rules remains very much an open question.

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